V. THE COMMISSION MUST PROVIDE FOR A SEPARATE COMPETITIVELY NEUTRAL MECHANISM TO COMPENSATE VERIZON FOR THE SHORTFALL TO THE EXTENT THAT THE UNE RATES DO NOT ALLOW VERIZON TO RECOVER ITS COSTS.

Both the Act and the Constitution require the Commission to provide for recovery of the ILEC's unrecovered prudent investment in facilities used and useful in providing wholesale service, and the actual operating costs and forward-looking investment costs that it will necessarily incur to provide those facilities. Thus, to the extent that the new methodology adopted by the Commission in this proceeding does not allow incumbents to recover these costs,[123/] the Commission is obligated to provide for a *separate competitively neutral mechanism* that will compensate for any shortfall.[124/]

A. The Constitution Requires That the Commission Establish a Separate Competitively Neutral Mechanism for Incumbents To Recover Their Prudently Incurred Historical Costs.

UNE rates are confiscatory if they fail to allow Verizon to recover the costs that it necessarily incurs to provide UNEs, including Verizon's past prudent investment Even in the traditional regulatory takings context, where a utility has voluntarily committed its plant to serving the public, the courts have recognized that the utility is entitled to recover "the capital prudently devoted to the public utility enterprise by the utilities' owners."[125/] In *Hope*, 320 U.S.

[123/] As discussed above in section III, both sound economic policy and the Constitution require that the Commission establish a pricing methodology that allows incumbents to recover their actual forward-looking costs through UNE rates

[124/] *See Preseault v. ICC*, 494 U.S. 1, 11 (1990) (the Constitution requires "reasonable, certain, and adequate provision for obtaining compensation at the time of the taking").

[125/] *Duquesne Light Co* , 488 U S at 309 (citing *Missouri ex rel. Southwestern Bell Tel. Co v. Public Serv. Comm'n*, 262 U.S. 276, 291 (1923) (Brandeis, J., dissenting)); *see also Democratic Cent. Comm. v. WMATA*, 485 F.2d 786, 808 (D.C. Cir. 1973) ("It is well settled that utility investors are entitled to recoup from consumers the full amount of their investment in depreciable assets devoted to public service.").

at 591, for example, the Court cited Justice Brandeis' opinion in *Southwestern Bell* to support the rule that "there be enough revenue not only for operating expenses *but also for the capital costs* of the business These include service on the debt and dividends on the stock." *Id.* at 603 (emphasis added). In addition, *Hope* makes clear that a rate order is compensatory if it provides "the opportunity for a return on *investment*." There can be no return *on* investment until there has been a return *of* investment.

The necessity of allowing a utility to recover its past prudent investment is even more pronounced in the UNE context, as Verizon has not *voluntarily* dedicated its plant to providing UNEs to competitors. Instead, the Act compels Verizon to enter that particular line of business, which is entirely unrelated to the retail telecommunications services it offers as a public utility. Moreover, to the extent Verizon made its investments pursuant to the regulatory regime that existed prior to the 1996 Act, the government must preserve the opportunity to recover the capital invested before the shift in regulatory regimes. In *Duquesne*, the Supreme Court determined that a new ratemaking methodology was not confiscatory because it produced recovery that was sufficient as measured *under the old methodology*. 488 U.S. at 312. Indeed, in a concurrence, Justice Scalia, joined by Justices White and O'Connor, observed that, for courts to determine whether a rate methodology provided a constitutionally adequate "fair return," "all prudently incurred investment may well have to be counted." *Id.* at 317.

The Commission has likewise recognized the need to consider the impact of the transition to a forward-looking ratemaking methodology on the recovery of past prudent investment. In the *Local Competition Order*, the Commission pledged that ILECs may "seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates" and stated that it intended to consider in its Access Reform Proceeding the creation of "a mechanism separate from rates for interconnection and unbundled network elements" to provide recovery of ILECs' historical costs. *Local Competition Order* at 15872 ¶ 739. In its *Universal Service Order*, the Commission again promised that it would address "legacy costs" in its Access Reform Proceeding.[126] And in its Access Reform Proceeding, the Commission again "recognize[d] the need to examine whether incumbent LECs should be compensated for any historical costs that they have no reasonable opportunity to recover as a result of the transformation from a regulated to competitive marketplace" and said it "intend[ed] to respond fully to concerns about historical cost recovery" that year.[127] The Commission should now fulfill that promise.

The ILECs' revenues from other sources — including both retail revenues subject to the jurisdiction of the states and revenue from competitive lines of business — may not be considered in determining whether UNE rates are compensatory. As an initial matter, it is axiomatic that where the government forcibly occupies a portion of a firm's property, it must fully compensate the firm for the portion so taken. *See Loretto*, 458 U.S. at 435-36. It is no answer to say that the firm's other remaining operations may nonetheless allow it to continue to operate at a profit. That is why the government unquestionably could not occupy and convert a General Motors plant to the production of tanks without fully compensating General Motors for the property taken The same principle applies here where a portion of Verizon's property has been forcibly dedicated to the use of its competitors — a business it did not choose to enter.

126/ Report and Order, *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776, 8901-02 ¶ 230 n.593 (1997).

127/ First Report and Order, *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; End User Common Line Charges*, 12 FCC Rcd 15982, 16003 ¶ 49 (1997)

Under those circumstances, the government must fully compensate Verizon for the property that is dedicated to that compulsory regime.

In fact, the law is clear that even where a firm *voluntarily* dedicates a portion of its property to a regulated business, a regulator may not force the portion of the business it is regulating to operate at a loss and claim that the deficiency can be covered by other parts of the firm's business. Thus, in *Brooks-Scanlon Co.*, 251 U.S. at 399, the seminal case applying this principle, the Supreme Court held that regulators could not justify below-cost railway rates by claiming that the railroad was still profitable due to healthy returns in its competitive lumber business As Justice Holmes explained, earnings from competitive operations are the firm's private property, and a firm "no more can be compelled to spend that [money] than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it." *Id.*

The same underlying principle is reflected in the rule that a regulator may not justify deficient rates by pointing to revenues from operations under a different sovereign's jurisdiction. As the Supreme Court has explained: "The state cannot justify unreasonably low rates for domestic transportation, considered alone, upon the ground that the carrier is earning large profits on its interstate business, over which, so far as rates are concerned, *the state has no control.*" *Smyth v. Ames*, 169 U.S.469, 541 (1898) (emphasis added); *see also Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930). Thus, as the Commission itself has acknowledged, in conducting a takings analysis, the agency "may not consider incumbent LECs' revenue derived from services not under our jurisdiction." *Local Competition Order* at 15871 ¶ 737 n.1756.

The "total effect" test from *Duquesne* does not lead to a different result. In *Duquesne* and *Hope*, the companies at issue were regulated monopolies in *all* their operations and had voluntarily dedicated their operations to the businesses that were being regulated. In those cases, therefore, it was proper to consider the company's overall revenue from all operations in determining the sufficiency of a rate order. But those cases clearly do not mean that, where a regulatory regime reaches only part of a business, that regulator can justify a non-compensatory rate on a regulated service by claiming that revenues from sources outside that regime make up the difference, especially where the relevant part of the business was *not* voluntarily dedicated. *See Brooks-Scanlon*, 251 U.S. at 399. Further, today, *all* of the ILEC's services are subject to competition from CLECs, wireless providers, cable operators, and others. Thus, any attempt to increase non-UNE rates to make up for shortfalls in the UNE rates could not work. There is a dynamic relationship between UNE rates and retail revenues: As UNE rates drop, CLECs are able to undercut the incumbent's retail rates and capture its customers. Raising the incumbent's retail rates accordingly would only accelerate the incumbent's loss of customers to CLECs Thus, far from making up for a shortfall in UNE rates, increasing retail rates would simply exacerbate the incumbent's loss.

Accordingly, to the extent that the new methodology adopted by the Commission in this proceeding produces confiscatory rates, the Commission must provide for a separate, competitively neutral mechanism that allows Verizon to recover its past prudent investment and its actual forward-looking costs. Such a mechanism would be consistent with actions taken by agencies regulating other industries. For example, when the Federal Energy Regulatory Commission ("FERC") changed its regulatory regime and implemented an "Open Access Rule" to bring about competition in the electric industry, it also provided a means for incumbents to be compensated for their unrecovered historical costs. The new rule encouraged competition by providing new power generators with non-discriminatory access to otherwise private transmission lines. In allowing recovery of historical costs, FERC reasoned that "[t]he Commission's goal is to ensure that customers have the benefits of competitively priced generation However, we must do so without abandoning our traditional obligation to ensure that utilities have a fair opportunity to recover prudently incurred costs and that they maintain power supply reliability. As well, the benefits of competition should not come at the expense of other customers."[128] Similarly, in managing the restructuring of the natural gas industry, FERC ultimately adopted a mechanism that enabled pipelines to recover losses forced upon them by the transition to new rules, a decision the D.C Circuit upheld in a series of cases as a reasonable "means to recover [the incumbents'] charges reasonably incurred under the prior regime."[129]

B. Actual Experience Demonstrates That the Shortfall Between UNE Rates and Historical Costs Is Substantial.

In the years since the TELRIC rules were adopted, UNE rates have failed to provide adequate compensation for incumbents' unrecovered historical costs, a shortfall that will increase if TELRIC is not reformed. As the attached declaration of Patrick Garzillo, Vice President of Service Costs in the Finance Department at Verizon, demonstrates, Verizon has performed a study showing the enormous gap between UNE rates set pursuant to TELRIC and rates based on Verizon's unrecovered historical costs. *See* Garzillo Decl. ¶¶ 5-6, 21, 23. The study relies on the investment, operating expense, and other data from Verizon's comprehensive 2002 ARMIS reports publicly filed with the Federal Communications Commission ("FCC"), and is thus transparent and verifiable *Id.* ¶ 4.

128/ *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, FERC Order No. 888, 61 Fed. Reg. 21,540, 21,550 n.105 (1996).

129/ *Public Util. Comm'n v. FERC*, 988 F.2d 154, 166-68 (D.C. Cir. 1993); *Western Resources, Inc. v. FERC*, 72 F.3d 147 (D.C. Cir. 1995).

Verizon's study demonstrates that UNE rates in place between 1997 and 2002 have already resulted in a substantial shortfall between the wholesale revenues Verizon has received for the UNEs it provided to CLECs and Verizon's historical investment in, and the associated operating expenses for, the facilities it has used to provide those UNEs. Garzillo Decl. ¶¶ 5-6, 31-32 For example, in New York alone, Verizon incurred approximately $2.4 billion in costs to provide UNEs from 1997 through 2003 that were not covered by the TELRIC rates. *Id.* ¶¶ 5, 31. Similarly, Verizon suffered cumulative shortfalls of over $188 million in Pennsylvania and over $145 million in Massachusetts due to the confiscatory TELRIC rates in effect during that same period. *Id*

Unless the Commission reforms the TELRIC methodology so that it more closely reflects incumbents' costs, this shortfall will only continue to grow, and at an accelerated rate. Indeed, under the existing TELRIC methodology, if the historical growth trends in the volume of UNE loops and UNE-Ps in service in each state that have occurred to date are projected to continue going forward, by 2005, the annual shortfall will reach staggering dimensions. Garzillo Decl. ¶ 6. For example, in Massachusetts, the annual shortfall for 2005 is projected to grow to over $135 million — more than three times the annual shortfall in 2002. *Id.* ¶ 31. And in New Jersey, Verizon could potentially suffer a $235 million shortfall, which would be nearly *seven times* the shortfall in 2002. *Id* [130/] Accordingly, the Commission should take action immediately and

[130/] And while UNE rates must themselves compensate the incumbent for the full costs of providing UNEs, so that broader company returns are *not* relevant to the takings analysis, the effect that UNE rates are having on total company revenues and returns *does* confirm that those rates are grossly below cost. For example, as TELRIC rates have dropped and UNE volumes have increased, Verizon's intrastate and total regulated rates of return have rapidly declined. Garzillo Decl. ¶¶ 32-35. In New York, as UNE-P growth accelerated from year-end 1999 to year-end 2002, Verizon's rate of return for all regulated businesses dropped from over 7 percent to approximately 0.75 percent, and its intrastate rate of return declined from more than 8 percent reform the TELRIC methodology in order to avoid perpetuating — and compounding — the confiscatory effect of the current TELRIC rules. And it should establish a separate and competitively neutral mechanism to compensate incumbents for any shortfall between UNE rates and their unrecovered historical costs.

---

to under 1 percent. *Id.* ¶ 34 Other states are exhibiting similar trends. *Id.* ¶ 35. The effect that below-cost UNE rates have on Verizon's net income from regulated businesses further demonstrates that those rates are non-compensatory. In New York, for example, if Verizon had leased approximately 20 percent of its total switched lines as UNE-Ps in 2002 — just a fraction above the total it did lease — its net income would have been *zero* as a result of the shortfall between the TELRIC rates in effect and the historical costs associated with the facilities used to provide UNE-P. *Id.* ¶ 37

VI. RATE ISSUES.

A. Deaveraging.

In the *NPRM*, the Commission asks whether it should retain the requirement of geographic deaveraging and whether it should also require rates to be deaveraged across different classes of service or customers. *NPRM* ¶¶ 136-37. Although the Commission should retain rate deaveraging for now, it should leave open the possibility of eliminating deaveraging over time as market conditions evolve.[131/]

The Commission should not, however, adopt deaveraging based on class of service or customer. Geography is more determinative of cost than either class of service or customer. As the Commission recognizes "there [is] no evidence that the cost of providing particular UNEs varies with the type of retail service or retail customer." *NPRM* ¶ 134 (citing *Local Competition Order* at 15883 ¶ 766). For example, the costs of providing service to a business customer and a retail customer in an urban area are more similar than the costs of providing service to a retail customer in an urban area and a retail customer in a rural area. Thus, geography is a sounder basis for deaveraging that the type of service or customer. Moreover, deaveraging based on customer or service may not even be technically feasible and, even if it were, would require major systems changes than would impose astronomical costs.

B. The *NPRM*'s "Productivity" Factor Proposal.

The Commission should not adopt general "productivity factors" to adjust UNE prices over time in lieu of conducting a full UNE pricing proceeding. *NPRM* ¶ 139. While forward-

131/ To the extent geographic deaveraging does not today make sense in particular cases (e.g. Washington, D.C.), that can be addressed through waivers. In addition, if the Commission does choose to retain geographic deaveraging, it should at least respond to one of the problems raised in the section 271 proceedings, *see NPRM* ¶ 133, by allowing ILECs to recalculate their deaveraged rates if a wire center changes zone.

looking expenses *should* reflect that inputs are based on the incumbent's actual experience and the labor savings it actually expects, the *NPRM* raises the idea of adopting a *standard* productivity factor to adjust expenses and investment (the two components of UNE pricing) and applying it every few years without analysis of whether the factor remains valid. That approach would be inconsistent with setting rates based on real, forward-looking costs. Such a one-size-fits-all standardized factor cannot be used to account for the incumbent's actual costs, and is indeed devoid of any real-world accountability. In addition, the use of productivity factors would likely decrease the transparency and verifiability of the states' ratemaking processes. *NPRM* ¶ 41.

Furthermore, a requirement to adjust rates using set productivity factors assumes that costs will always and regularly decrease. But, as noted above, there is no sound basis for such an assumption. As only one example, labor rates continue to increase, which would increase the costs for many UNEs. And in general, expenses in the telecommunications industry have been increasing over time, not decreasing, as demonstrated above. Indeed, the last time the Commission attempted to set a productivity factor under price caps, it sought to justify the factor it chose, in part, by arguing that there was a trend in productivity growth. The D.C. Circuit rejected the Commission's argument, finding instead that "the trend appears to be part of a cyclical pattern" during which productivity sometimes increases and sometimes decreases. *USTA v. FCC*, 188 F.3d 521, 526 (D.C. Cir. 1999).

Determining appropriate productivity factors would also be unnecessarily complex. First, there is no basis to assume that investment costs and expenses, even if one or both are decreasing, would do so at the same rate, which would make it extremely difficult to determine one overall productivity factor. In addition, different elements will have varying productivity gains over the planning period depending, for example, on the different types of technologies deployed and the amount of automation already involved in provisioning a particular element. Different elements would, therefore, require different productivity factors. As a result, a regulator would have to determine an appropriate productivity factor for *each* element. Shelanski Decl. ¶ 64. These determinations would have to be made separately for each state and each incumbent within the state. Moreover, there is no reason to believe that a productivity factor would stay constant over time; those factors would have to revisited and adjusted on a periodic basis. Thus, determining productivity factors would deteriorate into even more hypothetical assumptions and standardless "black box" exercises capable of producing any desired result. *Id.*

The Commission itself has recognized that "the prescriptions of prior productivity factors in the price cap formula have been the subject of extensive regulatory proceedings and litigation," and that "the controversy regarding the current status of the X-factor and the concurrent uncertainty over the resolution of the controversy disrupts business expectations and future investment decisions of both LECs and new entrants." *Access Charge Reform Sixth Order* at 13028 ¶ 160, 13034-35 ¶ 174 In fact, the Commission saw resolution of the controversy and elimination of the consequent business uncertainty as one of the benefits of adopting the CALLS proposal. *Id.*

VII. RESALE.

As the *NPRM* notes, the Eighth Circuit's decision in *Iowa Utilities Bd. v. FCC*, 219 F.3d 744 (8th Cir. 2000), vacates the Commission's original resale pricing rules, and the Commission has not provided any additional guidance on establishing wholesale discounts for resale rates pursuant to 47 U.S.C. § 252(d)(3). *NPRM* ¶ 142. Although the language of section 252(d)(3) is plain, the Commission's failure to act on the Eight Circuit's remand has led CLECs to argue that state commissions should continue to apply the Commission's pre-existing resale rules, or should put off setting a new resale discount until such time as the Commission issues new rules. Thus, in answer to the Commission's question in the *NPRM*, ¶ 143, the Commission must provide at least basic guidance to the states concerning the appropriate approach for estimating the resale discount under the Act.

As section 252(d)(3) itself, and the Eighth Circuit's decision make clear, the wholesale discount for resold services must reflect only those costs that the incumbent *actually avoids* when it provides the service to the CLEC at wholesale instead of retail. In vacating the FCC's resale rules, the Eighth Circuit held that:

> The language of the statute is clear. Wholesale rates shall exclude "costs that will be avoided by the local exchange carrier." 47 U.S.C. § 252(d)(3). The plain meaning of the statute is that costs that are actually avoided, not those that could be or might be avoided, should be excluded from the wholesale rates.

Iowa Utils. Bd., 219 F.3d at 755. The mandate in this ruling is unambiguous: The question in setting the resale discount is not what costs an ILEC *should* be able to avoid or would be able to avoid in a hypothetically efficient network, but what costs the ILEC will actually avoid by providing the service at wholesale rather than retail

The Commission should accordingly establish certain basic guidelines for state commissions determining the resale discount. First, as the Wireline Competition Bureau recognized in the *Virginia Arbitration Order,* whether or not it is retained for UNE-costing purposes (and it should not be), the TELRIC hypothesis of a fully competitive market is entirely irrelevant for the purposes of setting resale prices.[132/] The Act establishes separate costing regimes for UNEs and for resale. The latter turns on costs that the ILEC actually *will* avoid, not those it hypothetically *would* avoid in a perfectly competitive market.

Second, the Commission should confirm that the analysis of the costs the incumbent *will* avoid must account for the fact that the incumbent will continue to serve the retail markets (which of course it must, if there are to be retail services to resell). Again, because resale is firmly rooted in the real world, the discount cannot be tied to the assumption of a UNE-only company. As the Eighth Circuit observed, "[t]he statute recognizes that the ILEC will itself remain a retailer of telephone service . . . ." *Iowa Utils. Bd.*, 219 F.3d at 755. This means that certain overhead or "common" expenses will not be eliminated at all simply because a particular customer's retail service is replaced with wholesale service to a CLEC.[133/] The Commission itself recognized that, "[i]f a cost is common with respect to a subset of services or elements . . . a firm avoids that cost only by not providing *each and every* service or element in the subset."

[132/] Memorandum Opinion and Order, *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia, Inc., and for Expedited Arbitration, et al.*, 17 FCC Rcd 27039, 27365 ¶ 674 (2002) ("*Virginia Non-Cost Arbitration Order*")

[133/] *See* Alfred E. Kahn, Timothy J. Tardiff, and Dennis L. Weisman, *The Telecommunications Act at three years: an economic evaluation of its implementation by the Federal Communications Commission*, 11 Info. Econ. and Policy 319, 345 (1999) ("The costs that an ILEC will avoid by selling *some portion* of a service at wholesale rather than retail (i.e., the [long-run incremental cost] of some increment or decrement of its total retail sales smaller than the total) will undoubtedly be smaller, on a per unit basis, than if it were to abandon retailing entirely (thereby saving the [long-run incremental cost] of the entire service).") (emphasis in original).

Local Competition Order at 15845 ¶ 676 (emphasis added). The only costs that would decline as retail lines were lost to wholesale would be *volume-sensitive* costs, and few if any common overhead costs fall into that category. If the cost is not volume-sensitive, the company will have to bear it as long as it has *any* retail customers.

For example, the costs of the corporate leadership of the company, or the legal departments, do not decrease whether the services provided are wholesale or retail.[134] In addition, as long as *any* retail service is being provided, the company will need a billing department. Verizon will continue to advertise its retail services, even if it sells some of its services at wholesale, no costs will necessarily be avoided. Similarly, a large percentage of product management costs are not avoided simply because products or services are sold at wholesale instead of retail. Product management includes the development of products and services that are sold at retail to begin with and accordingly are available for resale: no matter how many lines were sold at wholesale, the continuing development of new retail products would be required.

Third, and relatedly, the Commission should make clear that it is *not* reasonable to assume "all marketing, billing, and collection costs are avoided." *NPRM* ¶ 144. Section 252(d)(3) suggest only that *any* such costs that *will* be avoided must be considered in setting the

[134] *See* Order, *Investigation by the Department of Telecommunications and Emergy on Its Own Motion into the Appropriate Pricing, based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided-Cost Discount for Verizon New England, d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts*, D.T.E. 01-20, at 123 (Mass. Dep't of Telecomm. & Energy July 11, 2002) ("With respect to legal expenses, we agree with Verizon that such costs (e.g. costs associated with purchasing equipment, negotiating contracts, negotiating rights-of-way and labor negotiations, defending accidents, regulatory activities such as filing tariffs and appearing before state commissions) are expenses Verizon legitimately incurs in the course of provisioning UNEs to CLECs and, thus, Verizon should be allowed to recover them").

discount. As noted, not all such costs *are* avoided simply because a particular order is provided at wholesale rather than retail. The ILEC bills for both retail and wholesale, for example. The *retail* billing costs would be avoided, but the wholesale billing costs obviously would not. Instead of adopting any such presumptions, the retail discount should be set based upon a study by the incumbent showing which costs reasonably will be avoided for each category of costs that the incumbent incurs in providing its retail services. Requiring incumbents to provide a detailed cost study is certainly more appropriate than adopting "presumptions" that may not be accurate with respect to a particular carrier and thus would not be consistent with the statute's "will be avoided" principle. *See NPRM* ¶ 144.

Fourth, the Commission should clarify that the resale pricing rules do not apply to features that are not provided on a stand-alone basis for purchase. In the *Virginia Arbitration Order*, the Wireline Competition Bureau declined "to establish wholesale discount rates for vertical features or other stand-alone services." *Virginia Arbitration Order* ¶ 677. Citing its decision in the *Virginia Arbitration Non-Cost Order*, the Bureau explained that "Verizon is not obligated to offer for resale more discrete services than it offers to its retail customers." *Id.* Thus, the Commission should affirm the Bureau's conclusion, and affirm that the discount applies only to "retail rates charged to subscribers for . . . telecommunications service[s] " 47 U S.C. § 252(d)(3).

For precisely that reason, the Commission concluded in the *Local Competition Order* at 15958 ¶ 917, that the Subscriber Line Charge ("SLC") is not a retail service to which the resale discount applies. *NPRM* ¶ 146. That decision should not be revisited here: The SLC is not a "service" offered to end users. Equally important, the costs that the SLC is intended to compensate simply are not *reduced in any way* when Verizon provides service to a reseller instead of a retail customer. Instead, the SLC is designed to compensate Verizon for the costs of using its facilities for interstate services, and these costs are still imposed on Verizon when the reseller, rather than Verizon, serves the end user.

Finally, the Commission should establish once and for all that the resale discount cannot be adjusted to provide CLECs with a greater margin. As noted above, section 252(d)(3) requires that the rate be determined by identifying which retail costs are actually avoided. In short, "Congress has directly spoken to the precise question at issue." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984). Providing CLECs with a more attractive profit margin because it might encourage more resale is not a lawful basis for ignoring the statutory standard and increasing the resale discount. "Regardless of how convincing the Commission's policy rationales may be, the Commission is without authority to alter congressional mandates."[135] In any event, if CLECs truly believe that ILECs could avoid even more costs if they were more efficient, they should be able to compete on the basis of the resale discount: more efficient marketing, billing and collection operations than the incumbent's should leave the CLEC with margin to spare.

---

[135] *Southwestern Bell Corp. v. FCC*, 43 F 3d 1515, 1520 n.1 (D.C. Cir. 1995). In any event, the statute clearly does not guarantee the CLECs a certain level of profit for reselling ILEC services "The purpose of the Act is to promote competition, not to favor one class of competitors at the expense of another." *U.S. West Communications, Inc. v. Jennings*, 46 F. Supp. 2d 1004, 1021 (D. Ariz 1999); *cf.* Memorandum Opinion and Order, *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Co., and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services in Arkansas and Missouri*, 16 FCC Rcd 20719, 20750 ¶ 65 (2001) ("The Commission has repeatedly stated that incumbent LECs are not required, pursuant to the requirements of section 271, to guarantee competitors a certain profit margin.").

VIII. PROCEDURAL ISSUES.

A. Implementation.

The Commission should establish a true-up mechanism for the difference between what a competitor pays under rates established pursuant to the current TELRIC rules and what competitors would pay for the same facilities under rates established pursuant to any new rules the FCC may adopt, dating back to the date of any rules issued in this proceeding. The Commission has already recognized that the existing rules are seriously flawed and frequently misapplied. State regulators and CLECs are now on notice that the rules may and likely will change and that below-cost rates based on extreme hypothetical assumptions were a short-lived phenomenon. CLECs therefore take UNEs from the date of the *NPRM*'s issuance and certainly the date of the new rules with full awareness that those rates will and should change and that they are receiving service without having to bear the full costs.

B. Modeling and Evidentiary Issues.

As we have explained, the Commission should require that cost inputs be based on real-world attributes of an incumbent's network. This would eliminate the speculation that currently occurs in UNE pricing proceedings and avoid the type of "black box" ratemaking that results under TELRIC. *NPRM* ¶ 7; *see also Triennial Review Order* ¶ 99 (noting a preference for actual market-based evidence because studies "based on estimates of costs and revenues . . . can be difficult to verify, and thus are more easily manipulated by advocates"). The Commission should also require that cost models used to analyze UNE costs must be capable of measuring real-world network costs The CLECs' models frequently are not. For example, AT&T's Modified Synthesis Model ("MSM") fails to show any change in loop cost impact when DLC assumptions change, even though the Wireline Competition Bureau noted that DLC assumptions are a significant component of loop costs. *See Virginia Arbitration Order* ¶ 303. Similarly, that model is incapable of modeling high capacity loop costs, as well as the costs of several other UNEs such as network interface devices ("NID"s) and subloops. *Id.* ¶ 332 (recognizing that "[t]he MSM generates costs, and therefore rates, for the basic 2-wire loop only."). While the Commission need not specify the particular model choice, it should clarify that cost models must be designed to account for all real-world network attributes.

The Commission expressed concern that a TELRIC framework tied more closely to the real-world attributes of the incumbent's network and the incumbent's engineering plans might create an information imbalance between incumbents and CLECs. *NPRM* ¶ 61. Any information imbalance can be addressed through concrete discovery rules. Federal and state courts deal with the information imbalance that is an inherent part of all litigation through discovery, and there is no reason to believe that state commissions could not do the same. Indeed, state commissions already rely heavily on discovery in UNE proceedings. However, the process is currently undisciplined and unlimited, which can seriously burden all parties, and, as the Commission has recognized, significantly lengthen the UNE proceedings. *NPRM* ¶ 61. By providing concrete discovery guidelines to the states, the Commission could both put to rest its concern about informational imbalance and streamline what has become an onerous process of discovery in many states. A more streamlined process would also consume fewer state commission resources and ensure that cases do not last so long that the cost studies become stale before the rates are even set.

First, ILECs could provide CLECs with some basic, well-defined accounting and plant-related data that would be essential for any carrier to develop its own cost studies prior to the filing of cost studies. This would allow carriers to have the basic information they need to develop their own cost studies from the outset ILECs could also provide basic accounting data on their domestic telecommunications investments such as the "6 digit account level" data contained in ILEC SEC filings. For outside plant information, ILECs could provide data regarding wire center locations or some other well-defined plant-related data. The Commission could establish that such information be routinely provided at the start of any UNE rate case, and should also provide that compliance with that requirement satisfies the ILEC's obligation with respect to such discovery and no additional requests relating to such matter may be proffered without a showing of cause. This approach would standardize the flow of information and avoid the lengthy piecemeal production of such data in response to numerous discovery requests.

Second, the Commission should require that, to the extent they challenge ILECs' cost data as too high or otherwise incorrect, CLECs must provide information and data concerning their own corresponding costs Thus, for example, if a CLEC claims that the ILEC's evidence concerning what it pays for switching equipment does not reflect appropriate prices, the CLEC should be required to provide information about what *it* pays for switching equipment. In UNE pricing proceedings today, CLECs routinely refuse to provide any information about their own costs and what they pay for various equipment, leading to extended discovery disputes that state commissions must ultimately resolve. While CLECs (and ILECs) should be free to argue about the weight that should be accorded CLECs' cost data, the Commission should make clear that CLECs are required to provide such data to the extent they challenge the accuracy or validity of ILEC cost data.

Third, the Commission should require all parties to file all of the relevant source data underlying their cost studies at the time they file their initial cost studies. This would eliminate the need for excessive discovery because the bulk of the relevant data would be put on the record up front. If CLECs use data from a source other than the ILEC's network to support their studies, they should be required specifically to identify the source of the data and specify whether the data is drawn from any real-world network or is simply hypothetical.

Fourth, the Commission should narrow the permissible scope of discovery to ensure that it is more closely tailored to the relevant information. One of the primary sources of delay in UNE cases results from unbridled discovery that can last for several months. For example, in California, SBC was required to respond to over 1,100 discovery requests. And even before the filing of Verizon's cost model in California, AT&T and MCI have served over 400 data requests on Verizon and Verizon has provided over 38,000 pages in response. In addition, AT&T and MCI have asked Verizon in California to provide: five years of accounting data; five years of various groupings of cost data in several requests (*e.g.*, OSS costs and NRCs); all contracts now in effect with Verizon's vendors; and all amounts invoiced to Verizon California by an affiliate and all amounts invoiced by Verizon California to an affiliate and which account the charge was booked.

To minimize lengthy discovery periods and voluminous requests for irrelevant information, the Commission should adopt certain basic guidelines. The Commission should provide that *no* discovery may be served until after the cost studies are filed, so that parties will have a basis to determine what relevant information they need. Because certain materials could be routinely provided prior to the filing of the cost studies and then with the studies, parties may have little real need for additional data and information. The Commission also should require that parties demonstrate how any additional materials or information they seek are relevant to supporting or rebutting the studies, by, for example, linking their discovery requests to the cost study by referencing specific pages or sections of the cost study, and demonstrate why the materials and information they do have is not in itself sufficient. This approach is similar to the one that the Commission uses for its own section 208 proceedings, and it would make it easier for the regulators to determine whether discovery is overly burdensome and unnecessary or serves a legitimate purpose in the case. This approach is also akin to the rules of Civil Procedure. Under Federal Rule of Civil Procedure 26(a), parties must provide certain specific information prior to discovery, including a list of documents that support the party's claim and a compilation of any damages, in order to limit subsequent discovery.

In addition, the Commission should adopt a cap on the number of permissible discovery requests. A carrier seeking to make requests in excess of that number must justify the relevance of the request to the state commission that will determine if the additional requests are necessary. This, too, mirrors the Commission's Section 208 discovery process. And discovery should be limited to a set period, such as two or three months, after the moving party files its cost study. This is reasonable because an ILEC will provide the data underlying its cost studies at the outset of the case. Some state and federal courts already have such an approach.

Finally, along with these procedural rules, the Commission could help streamline cost proceedings by identifying, wherever possible, objective sources for cost inputs. Thus, rather than simply adopt the general principle that TELRIC should be based on the incumbent's actual forward-looking costs, the Commission should provide the states with specific guidelines concerning what real-world data would be relevant with respect to the various inputs. For example, the Commission should not only provide that switching costs should be based on the mix of technology that the incumbent expects to buy, but should direct the states to rely on the prices the incumbent has actually received in the market. The Commission likewise could direct the states to presume that the incumbent's engineering plans and past deployment history should be relied upon to determine the appropriate forward-looking technology choices for a UNE study.

CONCLUSION

As set forth above, the Commission should reform TELRIC so that UNE rates are based on the incumbent's actual forward-looking costs and provide concrete guidance on how to set specific inputs based on objective, verifiable data about the incumbent's network, rather than unverifiable hypotheses.

Respectfully submitted,

Michael E. Glover /SA

Michael E. Glover
Karen Zacharia
Leslie V. Owsley
Verizon
1515 North Court House Road
Fifth Floor
Arlington, Virginia 22201
(703) 351-3100

Lynn R. Charytan
Samir C. Jain
Wilmer, Cutler & Pickering
2445 M Street, NW
Washington, DC 20037-1420
(202) 663-6000

Counsel for Verizon Telephone Companies

December 16, 2003

CERTIFICATE OF SERVICE

I, John Meehan, do hereby certify that true and accurate copies of the foregoing, Comments of the Verizon Telephone Companies, were served by hand delivery via courier this 16th day of December, 2003, to:

Chief William Maher
Pricing Policy Division
Wireline Competition Bureau
Federal Communications Commission
445 12th Street, S.W. 5th Floor
Washington, D.C. 20554

Qualex International
Portals II
445 12th Street, S.W , Room CY-B402
Washington, D.C. 20554

John Meehan